AP: US Default Could Be Disastrous Choice For Economy

April 23, 2011

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WASHINGTON -- The United States has never defaulted on its debt and Democrats and Republicans say they don't want it to happen now. But with partisan acrimony running at fever pitch, and Democrats and Republicans so far apart on how to tame the deficit, the unthinkable is suddenly being pondered.

The government now borrows about 42 cents of every dollar it spends. Imagine that one day soon, the borrowing slams up against the current debt limit ceiling of $14.3 trillion and Congress fails to raise it. The damage would ripple across the entire economy, eventually affecting nearly every American, and rocking global markets in the process.

A default would come if the government actually failed to fulfill a financial obligation, including repaying a loan or interest on that loan. The government borrows mostly by selling bonds to individuals and governments, with a promise to pay back the amount of the bond in a certain time period and agreeing to pay regular interest on that bond in the meantime.

Among the first directly affected would likely be money-market funds holding government securities, banks that buy bonds directly from the Federal Reserve and resell them to consumers, including pension and mutual funds; and the foreign investor community, which holds nearly half of all Treasury securities.

If the U.S. starts missing interest or principal payments, borrowers would demand higher and higher rates on new bonds, as they did with Greece, Portugal and other heavily indebted nations. Who wants to keep loaning money to a deadbeat nation that can't pay its bills?

At some point, the government would have to slash spending in other areas to make room for any further sales of Treasury bills and bonds. That could squeeze payments to federal contractors, and eventually even affect Social Security and other government benefit payments, as well as federal workers' paychecks.

A default would likely trigger another financial panic like the one in 2008 and plunge an economy still reeling from high joblessness and a battered housing market back into recession. Federal Reserve Chairman Ben Bernanke calls failure to raise the debt limit "a recovery-ending event." U.S. stock markets would likely tank – devastating roughly half of U.S. households that own stocks, either individually or through 401(k) type retirement programs.

Eventually, the cost of most credit would rise – from business and consumer loans to home mortgages, auto financing and credit cards.

Continued stalemate could also further depress the value of the dollar and challenge the greenback's status as the world's prime "reserve currency."

China and other countries that now hold about 50 percent of all U.S. Treasury securities could start dumping them, further pushing up interest rates and swelling the national debt. It would be a vicious cycle of higher and higher interest rates and more and more debt.

The U.S. has long been the global standard for financial stability and creditworthiness, with Treasury securities seen as a fail-safe investment. But after the near-shutdown of the U.S. government and a new credit-rating report this week questioning the country's fiscal health, Treasury bills and bonds are losing luster.

If there is a debt limit deadlock, the government by this summer could find itself legally unable to borrow more money to pay its bills, beginning with interest on its debt and gradually extending to day-to-day federal operations. At some point, the government would have to decide which bills to pay and which to put aside.

The debt ceiling will be hit on or around May 16, the Treasury Department says. Unlike the threatened government shutdown, the impact would start slowly, but then build mightily until the damage would be so dire that few political leaders or economists even want to contemplate it. The day of reckoning could likely be delayed at least until early July with creative bookkeeping.

When the House first rejected the Bush administration's $600-billion bank bailout in September 2008, the Dow Jones industrials went into a dizzying 778-point tailspin. A whiff of a possible similar stock market collapse came on Monday with a sharp selloff on Wall Street when the Standard & Poors lowered its outlook on U.S. debt to "negative" from "stable," possibly a first step toward a possible downgrade of America's coveted AAA credit rating.

"We haven't downgraded it. We just said, if nothing happens, we may have to," said S&P chief economist David Wyss. He said a government default remains uncharted territory, "which is one reason why it's not a good idea to hit the debt ceiling."

"There's reason to worry," said Wyss. "But my best guess is that we sort of muddle through this. Cuts will be made, they'll be too little too late, but at least they will be enough to maintain a triple-A rating."

"It's another game of chicken. And this time there are Mack trucks going at each other, not bumper cars. This is a biggie," said American University political scientist James Thurber. But he predicted that, as in the past, "there will be an accommodation. They will avoid a crash."

Investment bank J.P. Morgan Chase recently concluded that any delay in making an interest or principal payments by the Treasury "even for a very short period of time" would have large "long-term adverse consequences for Treasury finances and the U.S. economy." The analysis is being circulated on Capitol Hill by supporters of raising the debt limit.

"If anyone wants to push that button, which I think would be catastrophic and unpredictable, I think they're crazy," JP Morgan CEO Jaime Dimon said recently of those seeking to block raising the debt limit.

House Speaker John Boehner and most other GOP leaders agree on the need to raise the debt limit – and don't want to be held responsible for a new financial meltdown. Still, they want Obama to make more concessions on spending cuts than he has done thus far. That isn't sitting well with liberal Democrats, who think Obama has already given too much ground.

One reason the two parties can't find common ground: they can't even agree on what's causing high deficits. Democrats mostly blame it on policies of George W. Bush: two wars, tax cuts that continue to benefit the wealthy and an expensive prescription drug program. Republicans see government spending as the culprit, particularly on Obama's watch.

In fact, the main reason is the deep recession, which slashed tax revenues and led to hundreds of billions of dollars in recession-fighting spending by both Bush and Obama. The debt was $9 trillion in late 2007 before the start of the Great Recession, and it's just a sliver under the $14.3 trillion limit today.

Even though GOP leaders say they want to avoid more economic chaos, there is a large crop of tea-party aligned Republicans threatening to refuse to raise the cap under almost any circumstance. Polls suggest a large percentage of Americans oppose raising the debt limit.

The debt limit has been raised ten times over the past decade. Obama voted against Bush's debt-limit increase in 2006 as a senator, accusing Bush of "a leadership failure." Obama recently apologized for "making what is a political vote as opposed to doing what was important for the country."